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## Spirit Airlines: Achieving a Competitive Advantage Through Ultra-Low Costs

James Elia

Gerald N. Cook  
cookb01@erau.edu

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## ***SPIRIT AIRLINES: ACHIEVING A COMPETITIVE ADVANTAGE THROUGH ULTRA-LOW COSTS***

James Elian and Gerald N. Cook

### **Abstract**

Large losses between 2004 and 2006 brought Spirit Airlines to the verge of failure. With capital infusions from two private equity groups and a new cost focus strategy patterned after Europe's Ryanair, Spirit proclaimed itself an *ultra-low-cost carrier*. Spirit usually offers the lowest fare in its markets, but this base fare buys a seat with allowance for under-seat baggage only. Everything else, including a glass of water, is extra. Ancillary fees account for some 40% of total revenues. Although it has developed a customer base of price sensitive travelers, Spirit is also among the industry leaders in complaints. Nonetheless, Spirit should dominate the price sensitive U.S. air travel market in the short to medium term as it has achieved a sustainable competitive advantage based on Porter's cost focus strategy.

Since deregulation in 1978, the U.S. airline industry has struggled to achieve consistent profitability. No longer protected from competition on profitable routes, legacy carriers faced increased competition from each other and, more importantly, from new entrant airlines not burdened by rigid contract work rules and high labor costs inherited from the regulated industry. The first decade of the twenty-first century was particularly difficult for the industry as it was buffeted by successive world events including the terrorist attacks of September 11, 2001 and subsequent recession, the severe acute respiratory syndrome (SARS) epidemic, the dramatic rise and increased volatility of oil prices, and, finally, the global recession beginning in 2008. By 2012, the collective toll resulted in the bankruptcy of all surviving pre-deregulation legacy carriers. This led to airline consolidations and domestic capacity reduction resulting in much needed industry stability. While the low-cost carriers (LCCs) have generally continued to expand in the new millennium, the domestic airline product offered by the full-service and LCCs has converged to the extent that many passengers view the domestic economy class seat as a commodity (Tarry, 2010). An interesting recent

development is the emergence of the so-called *ultra-low-cost carrier* (ULCC) business model first developed in Europe by Ryanair and more recently introduced in the U.S. by Spirit Airlines. The ULCC business model strives to obtain a competitive advantage through a more aggressive implementation of Porter's cost focus strategy compared to traditional LCCs. By choosing to focus almost exclusively on minimizing costs, the ULCC business model results in a very focused target segment of those passengers who are concerned solely with obtaining the lowest price for air travel (Porter, 1998).

This paper is a case study of Spirit Airlines' aggressive implementation of Porter's cost focus strategy to transform from a small, struggling low cost airline serving gambling and vacation destinations in the eastern United States to a highly profitable and rapidly growing ultra-low-cost carrier with routes stretching across the U.S. and south to the Caribbean and Central and South America.

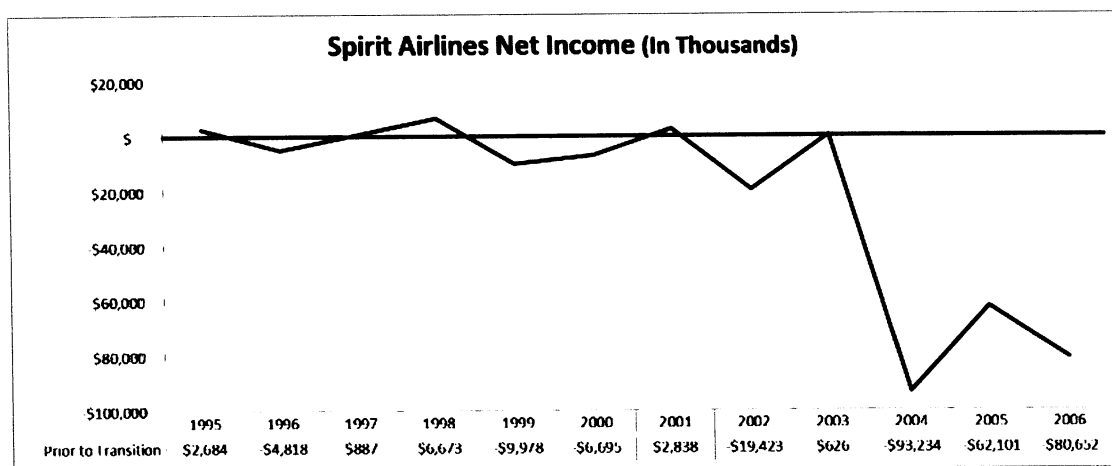
### **History**

Spirit Airlines traces its origin to the Clipper Trucking Company established in 1964. Twenty years later, with a new business plan and name, Charter One, the

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company began offering charter flights and tour packages to entertainment destinations, primarily from the Midwest to Atlantic City, New Jersey. By 1992, Charter One became Spirit Airlines with scheduled service promoting low fares, a strategy derisively termed *bottom feeding* by some due to having typical attributes of multiple extra charges and poor customer service (Flint, 1999). Spirit grew, primarily with expanded routes from the Midwest and Northeast to Florida, but it struggled with low and inconsistent profits as it had not fully committed to one of Porter's three generic competitive strategies: cost leadership, differentiation, or focus (Porter, 1998). Due to Spirit's lack of a competitive advantage, it incurred large losses from 2004 to 2006 that brought the airline to the verge of failure; it was rescued with capital infusions in 2004 and 2005 from the private equity investment firm Oaktree Capital Management. In 2006, Indigo Investment Group purchased controlling interest in Spirit, brought in new management and

implemented a business plan focused solely on providing the lowest price targeting a very narrow segment of the air travel market. Spirit thus proclaimed itself as an ultra-low-cost carrier (Spirit Airlines, 2011a). Although first in North America, Spirit's business model was patterned closely on the highly successful European carrier Ryanair that had itself adopted the strategy after operating for many years on a traditional LCC model originally developed by Southwest Airlines. On June 1<sup>st</sup>, 2011, an initial public offering (IPO) was completed taking Spirit Airlines public (Spirit Airlines, 2012a). The IPO was initially seen as a disappointment by many analysts; Spirit reduced the price and volume of the offering shortly before listing that resulted in a more than thirty percent reduction in capital raised ("Spirit Airlines IPO," 2011). Figure 1 illustrates Spirit's perilous losses beginning with the recession of 2001 and continuing until the adoption of the ultra-low-cost strategy.



**Figure 1.** Spirit Airlines Net Income from 1995 to 2006. Adapted from Department of Transportation Statistics and Spirit Airlines' IPO Prospectus (Spirit Airlines, 2011b)

A review of recent financial and operational data indicates that the ultra-low-cost model has proven remarkably successful. In 2012, Spirit was the fastest growing U.S. carrier with revenue passenger miles increasing 30.6% while available seat miles increased 27.5% driving its load factor to 84.8% (Hegeman, 2013). Moreover, Spirit enjoyed the second highest profitability of all U.S. major carriers for 2012 falling just behind fellow niche carrier Allegiant Air.<sup>1</sup>

### Strategy

Spirit's ultra-low-cost strategy is remarkably simple in concept and aggressively follows Porter's cost focus strategy for achieving a competitive advantage. As CEO Ben Baldanza often explains, "We're selling low prices, and compete for customers on the basis of price and price alone. In the retail world, we would be the dollar store." (Satchell, 2013). This strategy requires a very low cost structure, and Spirit has been innovative by unbundling many services which traditionally have been considered standard. The result of unbundling has been the ability to offer even lower base prices, while also achieving ancillary revenues that comprise 40% of Spirit's total revenues, the highest in the industry (Spirit Airlines, 2012b). Spirit's base price is usually the lowest in the market, but entitles the passenger to only a seat on the flight; all else, including a glass of water, is extra. Baldanza argues that these are options that a passenger may choose similar to the menu items at McDonalds and that passengers should not have to pay for services they do not need or value. Not all passengers are pleased, but the model is working leading USA Today to ask if Spirit is the nation's only true low-cost airline? (Jones, 2012).

### Target Market

Spirit's target market is narrowly focused on leisure and visiting friends and relatives (VFR) passenger segments. Leisure is the primary domestic segment with VFR second. Internationally, these segments are reversed

with VFR first followed by leisure. The product is carefully tailored for these price-sensitive travelers who are willing to sacrifice product amenities for a lower price. Spirit is disciplined in maintaining its focused market and unlike all other domestic carriers except Allegiant Air, does not actively target business and corporate travelers reasoning that its low frequency, limited routes, reimbursement policy, and lack of airport and onboard amenities have very limited appeal to the business segment so prized by other carriers (Spirit Airlines, 2012a).

### Route Architecture

The route map is thin but spans the contiguous states and stretches south into the Caribbean and Americas. Spirit lists several airlines as competitors. Across its route system, the principle competitor is American Airlines with 60% market overlap, followed by Southwest Airlines, United Airlines, and Delta Air Lines domestically, and JetBlue Airways in the Caribbean and Latin American markets (Spirit Airlines, 2012a). Spirit prides itself on not being subject to the traditional inefficiencies of the hub and spoke model (Spirit Airlines, 2012a); however, an examination of the route map (Figure 2) and timetable reveals a more complex reality. Ft. Lauderdale serves as a directional hub with morning southbound flights from Northeastern and Midwest states connecting to many Caribbean, Central and South American destinations. Flows are reversed in the afternoon/evening. Random connections are also available in other cities such as Dallas/Ft. Worth, Chicago and Detroit, but some routes stand alone without support of connecting traffic. Frequencies are low, often only once daily and not timed for peak demand. Spirit also defies the archetypal low-cost model by serving both highly congested major airports including Chicago O'Hare, Los Angeles International, and New York LaGuardia, among others, as well as secondary and low density airports such as Latrobe Pennsylvania and Phoenix Mesa.

<sup>1</sup> Author's calculation based on operating and net margin on revenue.

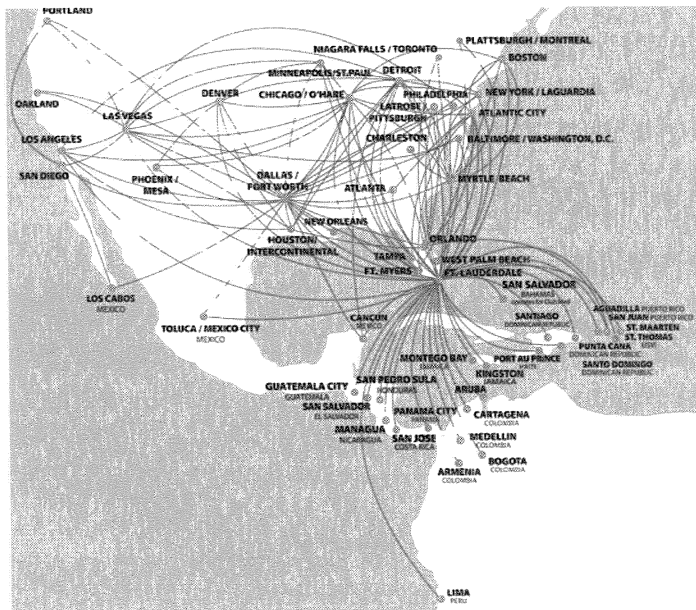


Figure 2. Spirit Airlines Route Network (Spirit Airlines, 2013a).

Spirit has recently been growing its domestic route system after several years of developing international markets in the Caribbean, Central and South America. Unlike many carriers, Spirit is unconcerned with market share when evaluating potential routes (Yeo, 2012). Nor does major carrier competition appear to be an important consideration as Spirit has been increasing destinations and departures from Dallas/Ft. Worth where American Airlines has been weakened by bankruptcy but Southwest Airlines is a strong competitor from its Dallas – Love home. For Spirit to consider a route for expansion there must be at least 200 passengers per day each way, the ability to reduce fares by at least 25% below existing levels, and the potential to earn an EBITDAR <sup>2</sup>argin of 24% to 26%. With these expansion

criteria, Spirit enters markets where low price stimulates demand from new passengers in addition to capturing some of the price-sensitive segment from incumbent carriers. Spirit maintains that more than 400 potential routes meeting these criteria have been identified (Ranson, 2012; Spirit Airlines, 2012b).

#### Fleet

Spirit operates the Airbus A320 family of single-aisle jets. Most are the smaller A319 model, but the airline plans to gradually standardize on the larger A320, including the next generation A320neo (new engine option). Operating a single fleet type confers substantial cost efficiencies including reduced training costs and accelerated learning curve, flexibility as crewmembers are qualified on all aircraft models, and reduced parts inventory. As of the end of 2012, Spirit had 45 aircraft in its fleet, with a substantial aircraft order book allowing for expansion to 113

<sup>2</sup> Earnings before interest, taxes, depreciation, amortization and rent.

aircraft by the end of 2021 (Spirit Airlines, 2013b).

#### **Product and Fare Structure**

Spirit's ability to promote low fares is based, in part, on the ultimate unbundled pricing strategy. The base fare buys a seat with allowance for under-seat baggage only (Yeo, 2012). All other amenities including checked and overhead carry-on baggage can be purchased for additional fees. Indeed, Spirit was the industry leader in charging for baggage. Table 1 shows a portion of the surprisingly complex system of baggage fees. Ancillary fees, of which there are 74 different options, also vary with the time and location of purchase with the highest fees charged at the airport just before departure. Figure 3 provides a breakdown of Spirit's ancillary revenues. Amenities are limited and there are no passenger lounges or on-board entertainment; "pre-reclined" seats are becoming standard and legroom is minimal. Passengers are expected to mostly handle their own processing. Customer service, when needed, is often rushed.

Spirit minimizes customer service costs, but this has contributed to its very high rate of customer complaints. For January, 2013, Spirit amassed 7.2 complaints per 100,000 fliers filed with the Department of Transportation, better than Frontier with 7.6 per 100,000 passengers, but some 22 times that of Southwest who garnered the best performance and more than 2.5 times that of the United Airlines which held the next worst position.<sup>3</sup> CEO Baldanza is largely indifferent passing off complaints as "an irrelevant statistic" (Miller, 2012). Spirit believes that passengers will repeatedly endure Spartan service in return for a low fare. As one passenger stated in a Yelp review, "I travel on Spirit all the time. I know they suck! But, for a cheap ticket, I will endure anything" (Seaney, 2012).

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<sup>3</sup> Authors' calculation.

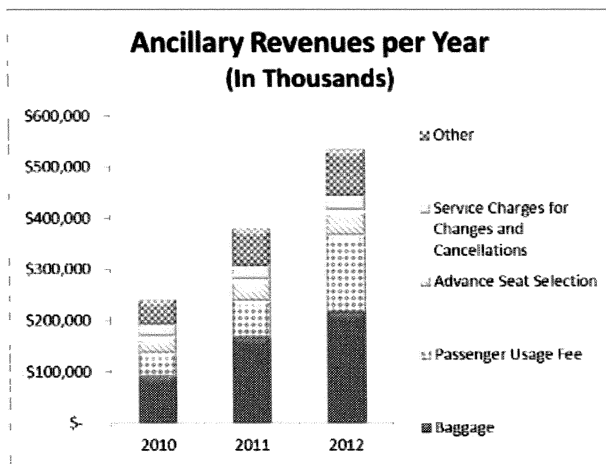


Figure 3. Spirit Airlines Ancillary Revenue. Adapted from Spirit Airlines' Form 10-K for the period ending 12/31/12 (Spirit Airlines, 2013b).

Table 1  
Spirit Airlines Ancillary Baggage Fees

	Carry-On Bag	1st Checked Bag	2nd Checked Bag	3rd-5th Checked Bag
At Booking	\$35	\$30	\$40	\$85
Online Check-In	\$40	\$35	\$45	\$90
Reservation Center Purchase	\$40	\$35	\$45	\$90
Airport Counter/ Kiosk Purchase	\$50	\$45	\$55	\$100
Group Booking >24 hours in Advance	\$35	\$30	\$40	\$85
Group Booking <24 hours in Advance	\$40	\$35	\$45	\$90
Gate Purchase	\$100 per Bag			

(Spirit Airlines, 2013c)

### Distribution and Promotion

Spirit maintains three distinct distribution channels. The website accounted for 64.2% of ticket sales in 2012. Third parties, including Global Distribution Systems (GDS), traditional travel agents and online travel agents (OTA) produced 27.2% of sales, with an outsourced call center representing the remaining at 8.6% of sales (Spirit Airlines, 2013b).

Although Spirit's embrace of traditional distribution increases its reach and sales, it isn't without problems. It distributes through Amadeus, Galileo, Worldspan and Sabre GDSs, but the airline reserves its lowest fares for its Spirit.com website ("Spirit Airlines, after IPO," 2011). When customers use Spirit's website, its additional fees and policies are prominently displayed. OTAs, however, show only the base fare leaving passengers surprised and occasionally irate when discovering what isn't included in the base fare. Baldanza attributes 100 percent of passenger complaints to sales through OTAs (Snyder, 2013). This is certainly an overstatement, but illustrates the limited ability of third party systems.

Spirit does not engage in general brand or product marketing and spent only 0.2% of revenues on marketing in

2011 primarily emphasizing low base fares. Principle marketing tools include the \$9 Fare Club, email distribution, and viral marketing products that send customers to the Spirit website (Spirit Airlines, 2012a).

Despite the lack of a substantial advertising budget, Spirit is well known for edgy, often off-color, advertising that has generated considerable free publicity, though often not positive. Notable are the "Hunt for Hoffa" campaign of 2006; MILF, Many Islands, Low Fares, in 2007; the "Eye of the Tiger" sale of 2009; and the 2010 "Check Out The Oil On Our Beaches" promotion (Bhasin, 2011). Email is the common method of communication.

### Cost Structure

Any firm employing a cost focus strategy must maintain unit costs lower than its competitors in its target segment (Porter, 1998). Spirit states its cost per available seat mile (CASM), a standard measure of airline costs, was 10.09 cents in 2012 (Spirit Airlines, 2013b). This compares with 12.85 for Southwest, 11.49 at jetBlue, and 14.91 cents for American Airlines. Table 2 provides a more detailed CASM comparison between the listed carriers.

Table 2  
Spirit Airlines 2012 CASM (in cents) versus competitors

	Spirit	Southwest	American	jetBlue
Fuel	4.16	4.78	5.24	4.50
Salaries, wages and benefits	1.93	3.69	3.76	2.60
Aircraft rent	1.27	0.28	0.33	0.33
Landing fees and other rentals	0.60	0.81	0.77	0.69
Maintenance, materials and repairs	0.44	0.88	0.68	0.84
Depreciation and amortization	0.13	0.66	0.60	0.65
Other operating expenses	1.56	1.75	3.52	1.88
Total CASM	10.09	12.85	14.91	11.49
Total CASM excluding Fuel	5.93	8.07	9.67	6.99

(Spirit Airlines, 2013b) (Southwest Airlines, 2013) (American Airlines, 2013) (jetBlue, 2013)

Spirit achieves low unit costs from (a) high aircraft utilization, (b) high-density seating aircraft configuration, (c) simple operations, (d) minimal hub-and-spoke inefficiencies, (e) a highly productive workforce, (f) opportunistic outsourcing of operating functions, (g) operating a modern single fleet type of aircraft, (h) reduced sales and distribution costs, (i) efficient flight schedule with

minimal ground times between flights, and (j) a company-wide business culture that is keenly focused on driving costs lower (Spirit Airlines, 2013b).

In a presentation to potential investors, Spirit boasted that its daily aircraft utilization of 12.7 hours exceeds jetBlue's rate of 11.9 hours per day, and Southwest's 10.5 hours per day (Spirit, 2012b). This increased aircraft utilization is partially



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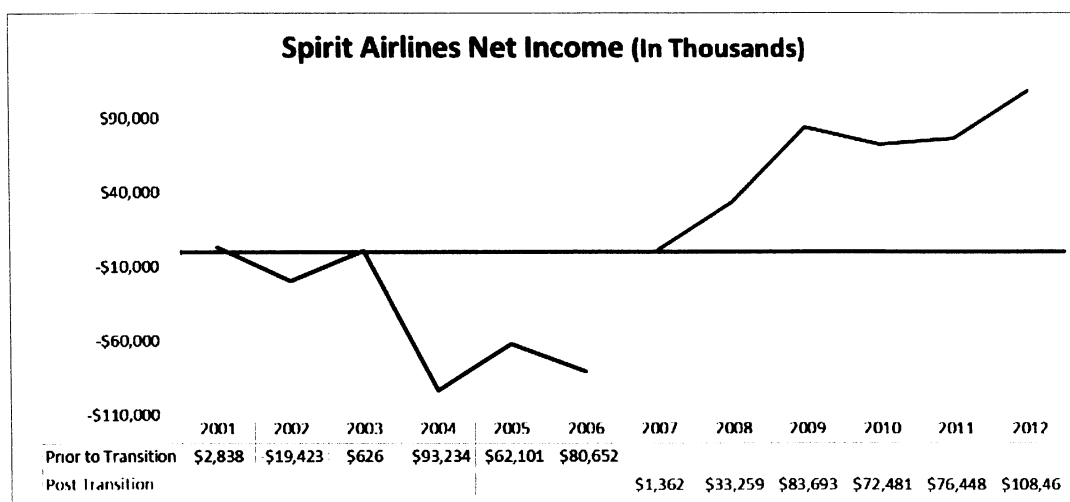
achieved through the operation of many “red-eye” flights. The unbundled pricing speeds ground turn-around times as high fees for carry-on baggage reduce the number of bags brought on-board which, in turn, enables passengers to quickly stow their items and take their seats. As a result, the standard boarding times have been reduced by 5 to 10 minutes (McCartney, 2010). By charging for all beverages, including water, fewer beverages are consumed. Catering time and expenses are reduced, as is fuel consumption due to the reduced aircraft operating weight.

Spirit configures its cabins with the maximum seats allowed by the aircraft certification. The new A320 aircraft are configured at 178 seats. This compares with jetBlue’s 150 seats for the same Airbus model giving Spirit a 16% cost advantage per available seat mile. Of course, high-density seating is achieved through reducing passenger legroom decreasing passenger comfort. Spirit also enjoys substantially lower labor costs than its competitors. These

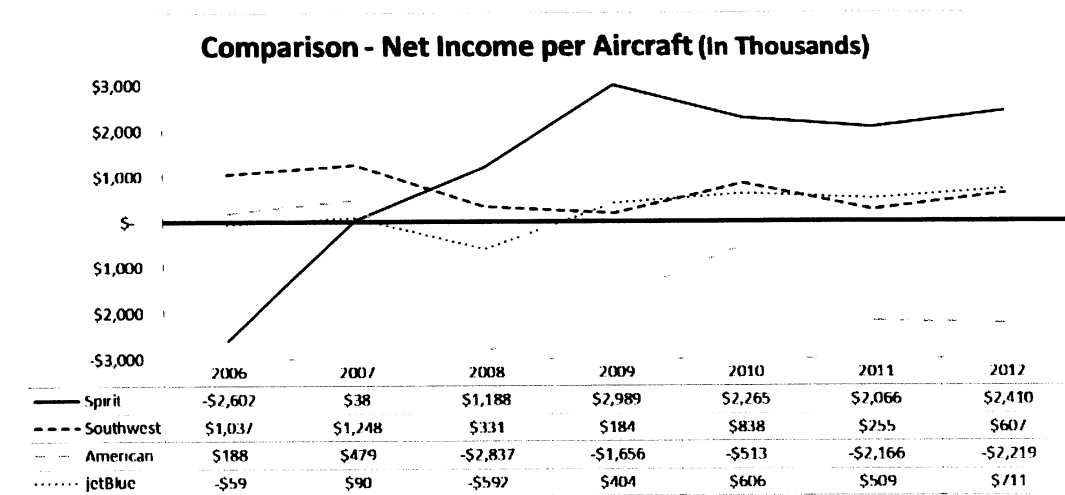
lower costs are partially due to higher employee productivity, but are also due to a relatively junior workforce resulting from the recent expansion (Spirit Airlines, 2013b).

### Financial Success

Since the introduction of the ultra-low-cost carrier business model in 2007, Spirit has been consistently profitable. Following a small profit that year, profits increased impressively with net income of \$33 million in 2008 and between \$72 million and \$108 million from 2009 to 2012 (Spirit Airlines, 2013b). The stock market also reflected Spirit’s success as the stock price, which closed initially at \$11.48 following the initial public offering in May 2011, more than tripled by September of 2013. Figure 4 illustrates the dramatic turnaround in profits while Figures 5 compare Spirit’s net income per aircraft with some of its competitors.



**Figure 4.** Spirit Airlines Net Income – Prior/Post business model change. Adapted from Department of Transportation Statistics, Spirit Airlines’ IPO Prospectus and Form 10-k from the period ending 12/31/12 (Spirit Airlines, 2011b) (Spirit Airlines, 2013b).



*Figure 5. Spirit Airlines Net Income by Aircraft – Comparison. Adapted from Spirit Airlines’ IPO Prospectus and from Spirit, Southwest Airlines, American Airlines, and JetBlue’s Form 10-k.*

### Analysis

#### Cost Focus Competitive Advantage

Following its decision to pursue the ULCC business model, Spirit sharply narrowed its targeted passenger segments to the most price sensitive leisure and VFR passengers. The timing of the strategic shift was fortuitous as the last decade has seen the distinction between economy class on full-service network carriers and the LCCs blurred as both moved closer to the others product offering. The Great Recession of 2008 drove many consumers in search of lower prices. Business traffic declined, but VFR and leisure passengers continued to travel as airlines chased passengers with reduced fares. Many passengers now view an economy seat as a commodity with the choice of airlines based largely on price (Tarry, 2010).

Spirit has achieved cost leadership in this narrow segment and the resulting financial performance has been impressive, especially given the historically dismal history of the U.S. airline industry. The business model of maintaining very low costs, focusing exclusively on leisure and VFR passengers, and the unbundling of services is

unique to the U.S. and has earned Spirit first mover competitive advantages, similar to those experienced by Ryanair in Europe. The result is that Spirit has been able to expand the overall market for air transport and successfully obtained a competitive advantage through the implementation of a cost focus strategy (Porter, 1998).

#### Risks

Porter lists several risks to companies pursuing focus strategies: (a) the ability for other companies to imitate the focus strategy, (b) the risk of the target segment becoming structurally unattractive, (c) the potential for broadly targeted competitors to overwhelm the narrow segment, or (d) new entrants taking a more narrow focus and subdividing the chosen segment (Porter, 1998).

The risk of imitation in the short term is unlikely in the U.S. as all other carriers, including those still labeled LCCs, target business clientele who demand more services. Allegiant is an exception, but competition between the two is limited and unlikely to escalate in the short-term as there are easier markets to enter than those which would result in competition between two price-focused carriers. The U.S.

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market is mature and fully serviced and there is no apparent opening for a new airline. The risk of a new entrant choosing a more narrow cost focus strategy and sub-segmenting Spirit's target market is also unlikely due to the already narrow focus on leisure and VFR passengers.

The risk of Spirit's target segment becoming structurally unattractive is unlikely. Boeing indicates that North American passenger traffic should grow at an annual rate of 2.7 percent over the next 20 years and that LCCs are currently leading capacity growth (Boeing, 2013). As the world economy slowly recovers and the average leisure traveler has more disposable income, some may abandon Spirit's product for other carriers offering a higher quality product and at least some amenities included in the base price; however, these passengers will likely be replaced with those who were previously unable to afford to travel by air. The risk of more broadly targeted competitors overwhelming the narrow segment is also unlikely in the short term. Existing carriers are heavily invested in their business models, which have also been profitable in recent years. While competitors may selectively challenge its pricing on some routes, Spirit's low frequency in most markets doesn't present a serious threat, at least in the short-term. Recent consolidation of U.S. carriers with their new emphasis on financial returns rather than market share also works in Spirit's favor. Over the last several years, the major network carriers and Southwest have restrained capacity and focused on higher yield passengers, largely abandoning the extremely price-sensitive passengers that Spirit targets. Should the largest carriers return to an emphasis on expanding domestic capacity and growing market share, competition for low-yield passengers would increase reducing Spirit's current competitive advantage.

One area of potential weakness that may be exploited by a potential competitor is Spirit's level of

service. The accepted wisdom in marketing holds that a firm must meet or exceed customer expectations to succeed in a competitive marketplace. But Spirit fails to meet the expectations of many passengers. Complaints to the U.S. Department of Transportation have long been at multiples of other airlines. A search of the web for complaints about Spirit reveals that it has earned the enmity of a host of passengers. One website, SpiritAirlinesFacts.com (n.d.), acknowledges that Spirit has its fans that "have learned how to travel within Spirit Airlines rules, and because of the perceived savings, they are happy to live with whatever inconveniences and indignities they are exposed to," but warns that many others have experienced ruined vacations and destroyed business plans. Whether Spirit can seemingly defy the established marketing wisdom in the long term remains an open question.

### Sustainability

Spirit's financial performance since completing the transition to the ULCC business model has been well above the industry average. After a disappointing initial public offering, Spirit's stock has more than tripled with analysts generally bullish on its prospects (Turcan, 2013) (Jayson, 2013). Spirit's target segment of passengers, focused primarily on price, is structurally attractive and expecting continued growth in the medium term. As the company matures employee wages will rise; however, expected growth rates should reduce some of the negative pressure as new employees join the company at the lower wage levels. Evaluating the known strategic risks, Spirit should not face a serious competitive challenge in most markets. As a result, Spirit should dominate the price sensitive U.S. air travel market in the short to medium term as it has achieved a sustainable competitive advantage based on Porter's cost focus strategy (Porter, 1998). →

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**James Elian** is vice president of operations and a pilot for a North American fractional ownership provider. Mr. Elian received his Master of Business Administration degree from the University of Calgary and is a Master of Aeronautical Science candidate at Embry-Riddle Aeronautical University.

**Gerald Cook** is an adjunct professor in the College of Business at Embry-Riddle Aeronautical University, Worldwide Campus and former airline operations manager and pilot. Dr. Cook received his Bachelor and Master of Science degrees from Purdue University and Doctor of Business Administration from Nova Southeastern University.

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